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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE GENERIC EVALUATION OF THE REGULATORY IMPACTS OF NON-TRADITIONAL FINANCING ARRANGEMENTS BY WATER UTILITIES AND THEIR AFFILIATES

DOCKET NO. W-00000C-06-0149

DIVERSIFIED WATER UTILITIES, INC.'S RESPONSE TO STAFF'S OCTOBER 6, 2006 REPORT AND FEBRUARY 9, 2007 LEGAL BRIEF

Diversified Water Utilities, Inc., ("Diversified"), hereby submits its response to the Staff Report dated October 6, 2006, and Legal Brief filed February 9, 2007 in the above captioned matter.

With respect to the issues presented in questions 1.A., B. and C. of the non-traditional financing inquiry letter dated June 2, 2006 ("Letter") from the Ernest G. Johnson as Director of the Utilities Division, Diversified's position with respect to those issues is that the ultimate decisions by the Arizona Corporation Commission ("Commission") should allow for consistency between all water utility providers regulated by the Commission so each regulated water provider will be allowed to use the same financing processes and systems of utility related third-party entities either directly by the utility itself or through its own related third party entities to create the same result regardless of the size of the water utility.

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With respect to questions 2, 3 and 4 of the Letter, Diversified again asserts that the financing issues addressed in the Letter are too important and complex to be based upon any formula. Diversified believes that there must be flexibility regarding these critical capital resource issues in light of the realistic financial operating limitations of a water utility with the primary and overriding concern being the financial health and operating ability of the water utility for the benefit of its customers, as more specifically set forth in Diversified's letter to Director Johnson dated June 23, 2006, a copy of which is attached hereto as Exhibit "A" and incorporated herein.

RESPECTFULLY SUBMITTED this 28th day of February , 2007.

DIVERSIFIED WATER UTILITIES, INC.

Scott W. Gray, President
2850 East Camelback Road, Suite 200
Phoenix, Arizona 85016

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ORIGINAL and 13 COPIES of the foregoing
filed this 28th day of February, 2007, with:

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COPY of the foregoing mailed/delivered
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Quality Water
Quality Service

Member, AWWA
AWPCA
WUAA
EVWF

June 23, 2006

HAND-DELIVERED

Ernest G. Johnson, Director
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007-2927

Re: Inquiry on Financial Structures for Water Utilities
Docket No. W-00000C-06-0149

Dear Mr. Johnson,

Thank you for allowing us to comment on the Staff Questions listed in your letter of June 2, 2006 identified as Docket W-00000C-06-0149. We believe the questions address very important matters that can significantly affect the quality of water services provided by growing water utilities regulated by the Arizona Corporation Commission ("ACC") and the financial viability of existing ACC water providers.

Our comments are as follows:

1. Questions 1. A., B. and C. We are not familiar with the various structures for owning ACC regulated utilities but understand the concern presented by these ownership structures. We do not have sufficient experience to address the issues presented in Questions 1.A., B. and C.

2. Question 2. We believe that setting a maximum or limit for "Advances in Aid of Construction" ("AIAC") for ACC regulated water utilities either in an amount or as a percentage of total capital is not a good policy and would result in significant problems for growing water utilities. The financial costs to increase water production to service new developments is significant and must be paid by either (i) the utility and passed on to its customers through increased rates, or (ii) the developer benefiting from the increased water production. The use of AIAC without a maximum limitation results in appropriate growth of a water utility minimizing the cost to the utility's customers. The longstanding ACC policy of allowing water utilities to require AIAC without maximum limitation is based on sound principals for the following reasons:

   a. First, AIAC funds are an important, and sometimes the only, source of funds to an ACC water utility to expand the plant and production

EXHIBIT A

capabilities of the utility. ACC water utility revenues from water sales are limited and generally cover normal operating costs plus a reasonable profit. The ACC water utility does not have the right to levy taxes for improvements. ACC rates do not allow an ACC utility to stockpile cash for the high cost of additional production for future development. Additionally, the growth of an existing water system is not within the utility's control or detailed planning ability. The growth of a water utility is generally determined by the real estate developer's building project schedule which changes based on market conditions. Real estate developers generate large amounts of immediate cash through real estate sales. Conversely, a water utility is a very different type of business that produces a slower income stream produced only after the water expansion project has been built, which income stream does not exist at the time of the needed capital. Access to the total necessary AIAC funds for a water improvement project makes sense and works for the water utility business and the real estate developer business. Having the necessary AIAC funds to build the entire water production plant needed for a project allows the water utility to build the necessary water production project and, if the development is successful, increase its revenue from additional water sales and repay the builder from the additional cash flow.

b. Second, the use of AIAC funds for the entire project benefits the customer. A utility does not obtain a return when AIAC funds are used keeping the costs for service lower and reducing the pressure on higher rates. The customers must pay in their rates a reasonable return on any water utility equity used for the real estate development project which would not be paid if AIAC funds were used. If AIAC funds are limited, the customer would pay a higher cost for water service while subsidizing the real estate developer's project.

c. Third, the use of AIAC funds for the entire project properly places the burden and risk of the expansion on the real estate developer. If the project is successful, the developer is repaid by the utility from operations. If the project is not successful, the utility does not have the financial difficulties from the failed real estate development project.

d. Forth, the use of AIAC funds for the entire project protects the financial health of the water utility. Financial capital is an important part of any business. No business has an unlimited supply of financial capital.

Capital is needed for the many requirements of a water utility that are not covered by the AIAC funding rules. Water utilities need equipment, backhoes, tools, improvements to existing plants, software, SCADA systems, etc. that are not covered by AIAC funds. Forcing a water utility's financial capital into the water production expansion project for a real estate development may not be the best use of a water utilitiy's funds at that time for the utility and may place a water utility in financial danger. If the development growth slow downs, a developer does not complete a real estate development or the real estate development does not sell, the water utility's capital may be lost, hurting the utility and it's customers.

e. Fifth, AIAC funds for the entire water project are provided by developers as a normal building cost of their real estate projects. This utility improvement cost is paid today by a builder whether the development is (i) in a city-owned water system through the payment of governmental entitlement-infrastructure fees, or (ii) in an ACC water utility as an AIAC or Contributions in Aid of Construction ("CIAC") cost. To limit or restrict AIAC payments will only result in financial gains to the real estate developers for costs they now expect to pay and would continue to pay to a city-owned water systems.

3. Question 3. For the same reasons set forth above in Question 2, we believe that setting a maximum or limit for CIAC for ACC regulated water utilities, either in an amount or as a percentage of total capital, would also result in the same significant problems for growing water utilities. The longstanding ACC policy of allowing water utilities to require CIAC without a maximum limitation is based upon the same sound reasoning as the AIAC rules. It should be noted that the CIAC is the most inexpensive cost of funds to a utility because it does not have to be repaid to the real estate developer. The CIAC is consistent with the costs to real estate developers for development in city-owned water systems and is a common cost to developers. CIAC funds protect the financial health of water utilities by eliminating the obligation to repay. CIAC funds also minimize the pressure to increase water rates benefiting customers.

4. Question 4. We do not believe that there is a definable capital structure for new water or wastewater utilities and that each new utility must be reviewed to determine the experience, capability and success of those involved in the proposed company and the needs of the community it serves. We believe that the placement of a pre-determined amount of equity may result in the best

operator being excluded from consideration. We believe that a new utility should be required to have sufficient capital when it is formed to meet its reasonable operating needs to be viable. However, we urge the ACC to recognize any capital structure analysis is not a significant test for existing operating utilities because (i) capital does not represent any actual cash reserve funds available to the utility and generally is historic only being already consumed for infrastructure and operating needs, (ii) it is not possible or reasonable to have an initial capitalization address unknown future development requirements in an expanding and growing water utility which can have significant financial expansion costs by large growth requirements (currently properly supplied by AIAC and CIAC funds) and for the reasons set forth above in Questions 2 and 3, and (iii) existing water utilities can be judged by their operations, compliance and customer relations which are the true tests for a successful utility. Equity is not a significant indication of the utility's ability as an existing operating utility.

The problems and risks that are caused to a utility from placing a maximum limit on AIAC or CIAC funds are much greater than any perceived benefit from requiring some equity amount. Though we do not know the reason the ACC is inquiring about limitations, if the ACC is concerned about the health and dedication of the water utility, we suggest that there are many areas that allow the ACC to determine the dedication and ability of the utility from the compliance with rules and regulations, customer experience, and its success or failures. Poor operators will continue to be poor operators regardless of any capital investment. No company can be expected to have unlimited sources of revenue and high growth can have substantial costs that can only be addressed through AIAC and CIAC funds for the entire requirements of the project. Alternatively, if such funds are limited and an expanding utility does not have access to the necessary development costs needed for the water production project, the problems that will result will adversely impact the company, the developer community, the customers and consume a significant amount of ACC time and effort. We request that the ACC not allow the concerns addressed at Questions 1.A., B. and C. to detrimentally impact the long-standing reasonable and necessary rules governing AIAC and CIAC.

We also ask the ACC to include in its consideration of these questions its other important policies of promoting efficiencies and water utility systems sized in a manner beneficial to that utility and it's customers.

Thank you again for letting us address these questions. Please contact me if you have any questions regarding this letter or if I may be of any assistance to you on these matters.

Very truly yours,

Scott W. Gray
President

SWG:lme